6/6/88 B 5350-3

MANUFACTURERS HANOVER

Economic Report

June 1988

Commentary on Pertinent Economic Issues

Where's the Recession?

Irwin L. Kellner
Chief Economist

As the U.S. economy prepares to round the midyear turn, it seems fairly obvious that it did not lapse into the recession that many economists had expected to occur right after the stock market's collapse last October. To be sure, spending patterns did change abruptly. Sales of new cars and new homes plunged in fourth-quarter 1987 compared with the third. Indeed, domestic purchases by both consumers and business fell at an annual rate of 1½ percent, following a rise at a rate of nearly 7½ percent in the third quarter. However, outlays rebounded in 1988's first quarter, and have apparently risen further in the second. This has allowed business to work down some of the inventories that piled up late last year, in the wake of the spending cutbacks, without having to slash output schedules to the point of laying off workers, thus impacting confidence and buying power.

Does this mean that the worst is over? Or could it be that the recession has merely been postponed, rather than cancelled? Here are some questions concerning the outlook:

Manufacturers Hanover Economics Department 17/270

You've been forecasting a recession for 1988, yet, if anything, the latest batch of economic statistics seems to suggest just the opposite—an economy that's on the verge of overheating, with rising inflation and interest rates.

Exactly why we expect a recession! That's how they usually begin: An ebullient economy leads to faster increases in prices, which, in turn, cause the Federal Reserve to tighten the credit reins, boosting interest rates in the money markets. Bond market rates go up as inflation expectations heighten, and both produce a decline in stock prices. This leads to a drop in wealth and confidence among consumers, who usually respond by reducing their spending, leaving business with a pile of unsold goods. As business cuts excess inventories, people lose their jobs, spend less, and the process is repeated enough to produce a recession.

But didn't you expect a recession to begin earlier, right after the stock market crashed?

Yes, we did. As a matter of fact, even *before* the stock market crashed, we were predicting that the economy would enter into a recession sometime late in 1987 or in early 1988. In forecasting a recession for 1988, we expected the stock market to decline, because that's what usually happens prior to recessions. Last August, for example, we were about the only group looking for stocks to end 1987 at much lower levels than they were at that time. We clearly did not expect the decline to come all at once; the ensuing crash, like a summer thunderstorm, had the effect of cooling off the economy, which *was* experiencing rising inflation and interest rates. The Fed loosened monetary policy, interest rates came down, the dollar jumped in foreign exchange markets, and inflation pressures were suppressed.

You have said on previous occasions that, while not every decline in stock prices has led to a recession, the only time in this century when a plunge in stock prices the size of the decline between August 25, 1987 and October 19, 36 percent, was *not* followed by a recession was just at the start of World War II, when the military buildup offset the depressing effects of a big plunge in stocks. Obviously, we are not at war today, so how do you explain the fact that, after a brief dip, spending is once again climbing?

First of all, one should be aware that the stock market has risen close to 13 percent since October 19. That's helped to boost confidence, somewhat. In addition, it would appear that the market ran up so fast earlier in 1987 that few people realized they had such strong gains. In addition, most still have a profit in stocks they've held onto, and relatively few people own stocks directly, anyway. Combine all this with the drop in interest rates, and the aging expansion received a new lease on life from a development that practically everyone expected would do just the opposite.

Copyright 1988 Manufacturers Hanover Corporation 270 Park Avenue, New York, NY 10017

Then why are you still looking for a recession?

From another development that practically everyone thinks will do the opposite—what appears to be current strength in domestic spending and production. Even with April's decline, retail sales were running at a rate some 3½ percent ahead of the first quarter's levels. For its part, industrial production surged by an annual rate of eight percent in April, after having risen at a tepid 2½ percent clip in the first quarter. Along with such other seemingly bullish statistics as the employment and unemployment data, these figures have dissipated recession concerns and brought on euphoria. But they have also led to increased fears of inflation, and a jump in interest rates.

Well, if the economy is this strong, can't it withstand a mild dose of tighter money and higher interest rates?

Who is to say that the recent round of monetary tightening and rising interest rates has ended? The fixed-income markets may not be satisfied until there's enough evidence that the economy is cooling off. And by then, it may be too late to avert a recession.

Why do you say that?

Because the economy is not as strong as it looks. Spending by half of the private economy was lower in the first quarter of 1988 than it was back in third-quarter 1986! By this, I mean actual consumer purchases of hardgoods, softgoods, spending on housing, and business outlays for physical plant. Consumption of goods in particular has declined about 2½ percent over the past 18 months. At the same time, production of goods destined for consumers has jumped by nearly seven percent.

Are you suggesting that inventories are too high?

Yes. And while there was a decline in the rate of inventory accumulation reported in the first quarter's GNP, it seems to be insufficient, given what other data indicate—and given the fact that 80 percent of the growth in the previous quarter was accounted for by a jump in stockpiling.

Then you believe that capacity pressures are not as bad as they seem?

Once business realizes that it is producing far in excess of final sales, output growth will moderate and capacity utilization will decline. But even at April's levels, capacity use is not as intense as it appears. For one thing, while the overall operating rate may be at an eight-year high, at 82.7 percent, April's rate was more than four percentage points below December 1978's high. What's more, there were about a dozen major industries that in April were operating below rates reached as recently as August 1984! The really high rates you've been reading about are confined to only a few industries.

Then how do you explain the surge in business spending on equipment?

Easy. Businessmen have concluded that they cannot rely only on the value of the dollar to help restore their competitiveness both here and abroad. For one thing, the dollar is down significantly only against the major currencies, and not against such others as those of the Pacific Basin developing countries—the source of more and more of our imports. For another, who can guarantee that, even where it has fallen a lot, the dollar will stay down? Installing the newest machinery and equipment will enable companies to produce goods more efficiently—that is goods of higher quality at a lower cost—but it won't necessarily add to capacity. As a matter of fact, spokesmen for several major corporations have stated that they do not wish to add to capacity—although they do want to be able to produce more efficiently.

The latest figures show a substantial improvement in our trade deficit. Since imports are still rising, this must mean that the nation's exporters are enjoying a significant increase in demand. Doesn't this help the economy?

It definitely helps some industries and those regions of the U.S. where manufacturing is concentrated. However, keep in mind that exports make up only 10 percent of our GNP—they can't keep us out of recession all by themselves.

But surely, rising exports will help reduce our trade deficit.

It can't hurt—but I would not count on

exports alone to solve this problem. For one thing, imports are more than half again as large as exports; the trade deficit would shrink faster if imports were to come down as well. Second, many exporting industries are running at top speed; they cannot produce any faster. Third, most of our trading partners are either restricting imports from us, or are experiencing softness, themselves. Finally, as noted above, the sources of our trade deficit seem to be shifting away from Japan and Europe, to the "Four Tigers" of the Pacific Basin (Hong Kong, Singapore, South Korea and Taiwan), against whose currencies the U.S. dollar remains overvalued.

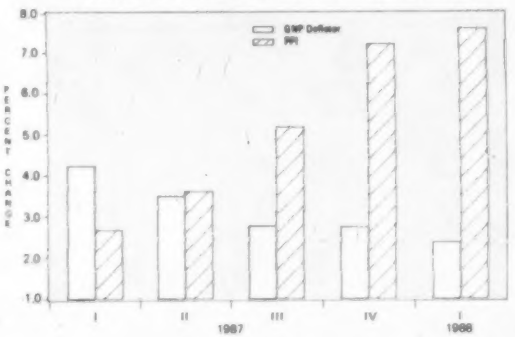
You say that the economy is weak, and that we may be heading into a recession. Yet, most economists and the markets fear the opposite—they think the economy is so strong, that we're more likely to overheat and experience a return to rapid inflation. What are they looking at that leads them to this conclusion?

Besides looking only superficially at capacity utilization, those who are worried about resurging inflation are focusing on such developments as the 45 percent jump in prices of industrial raw materials since August 1986; the progressively faster rise in producer prices of intermediate goods excluding food and energy since the middle of that year; April's fourteen-year low rate of unemployment, along with the record rate of employment, and the recent runup in foodstuffs' prices.

Doesn't this worry you, too?

While one should always be vigilant when it comes to inflation, it's not at the top of my worry list at the present time. For one thing, prices of two very important items—oil and labor—are *not* climbing steeply. Crude oil prices are well below their highs of last summer—not to mention two years earlier, when the posted price was $28 per barrel. And while labor markets may appear tight, labor does not seem to be either willing or able to translate this into higher wage rates, since labor costs per unit of output have risen only about two percent over the past year—half the rate of two years ago, and only a fraction of the double-digit rates common between 1979 and 1982. For another, people—both consumers and businessmen—are resisting paying higher prices, witness the progressively *slower* rate of rise of the GNP price index, or deflator, over the past four quarters (chart). Of all the measures of inflation, this is the most accurate, because it reflects current consumption patterns—not those of some earlier period. In other words—people are shunning those goods whose prices are rising more rapidly, and are buying instead, those goods whose prices are going up more slowly, if at all.

GNP DEFLATOR VS. PRODUCER PRICE INDEX FOR INTERMEDIATE GOODS EXCLUDING FOOD AND ENERGY
(QUARTERLY PERCENT CHANGES AT ANNUAL RATES)



And they are able to enforce this price discipline on the economy because of the weakness you referred to earlier?

That's correct. This is the other side of the fact that spending by half the private economy was lower in first-quarter 1988 than it was 18 months earlier.

What will happen if interest rates continue to rise?

They will slow aggregate economic activity the way they've already affected housing, which in April was 4½ percent below year-ago levels. It won't take much more of a rise to reduce sales of such other big-ticket consumer items as autos, home appliances and household furnishings, since consumer debt is at a record high relative to income, savings rates are below average, and buying power is virtually flat. Needless to say, rising interest rates are anathema to stock prices, so another sharp drop in prices of equities could develop which would also push the economy lower by cutting into both wealth and confidence, and by making it more difficult for business to raise money. Thus the long-expected recession would finally arrive, albeit a bit late—and when least expected. ■

MANUFACTURERS HANOVER

Commitment

Great Cause, Great Golf!

The Manufacturers Hanover Westchester Classic®
presented by NYNEX
Westchester Country Club
Harrison, N.Y.

June 6-12, 1988

Last year, the Manufacturers Hanover Westchester Classic raised $2 million, becoming the first PGA Tour event to reach this figure. During the last 22 years, this event has raised over $12 million for the 16 area hospitals. This is a special tribute to all the volunteers, fans and corporations who continually support this great charitable event.

This year, Greg Norman, Seve Ballesteros and other top pros from the PGA Tour will compete for $700,000 in prize money.

Tickets are on sale at all the participating hospitals through June 3, thereafter at the gate. Use your Mastercard or Visa Card, by calling (212) 808-8100, Monday through Friday, 9 a.m. - 5 p.m.

Spectators are urged to arrive early and be among the first 1500 each day to receive a free visor at the gate. **Make it a point to stop by the Expo '88 tent behind the 18th green for exciting exhibits and dining.**

Benefiting Hospitals: United, Lawrence Auxiliary, New Rochelle, Northern Westchester, Phelps Memorial, St. Agnes, St. John's, St. Joseph's, St. Vincent's, Blythedale Children's, Greenwich, Mount Vernon, White Plains, Yonkers General, Peekskill and Putnam Hospital Center

NABISCO BRANDS

© 1988 Manufacturers Hanover. All Rights Reserved.

MANUFACTURERS HANOVER

Manufacturers Hanover Corporation
Bank Window, Church St. Station
New York, N.Y. 10015

First Class Mail
U.S. Postage
PAID
New York, N.Y.
Permit No. 5766

644 644012385 C 928 GARNE0001
SUSAN GARNER
SRI ACQUISITIONS
CONGRESSIONAL INF. SERVICE
4520 E. W. HIGHWAY, SUITE 800
BETHESDA, MD 20814